MANAGEMENT SYNERGIES

Aligning Enterprise Risk Management with Strategy Through the BSC: The Bank of Tokyo-Mitsubishi Approach

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Following the wide-scale success of its Americas headquarters' BSC implementation (*BSR* November–December 2002), international banking giant Bank of Tokyo-Mitsubishi (BTM) launched a global BSC implementation from its Tokyo headquarters. Led by President and CEO Nobuo Kuroyanagi, BTM has thus embarked on a journey to use BSC as an enterprisewide strategic management tool. In the process, BTM is undertaking a groundbreaking application of the BSC: integrating it with enterprise risk management. As a corporate governance instrument, this integrated model—and BTM's application of it—is sure to capture attention.

When BTM adopted the BSC developed by its regional headquarters, it first had to modify the tool make it more suitable for global use. For example, Corporate Social Responsibility (CSR), a tenet that most corporations are obligated to embrace, is now incorporated in one of the strategic themes. In addition, the Plan-Do-Check-Act cycle, an enterprisewide initiative, has been integrated into each of the customer, internal process, and learning and growth perspectives to promote a customer-focused mindset.

But the most important addition BTM has made to the design originally developed at its Americas headquarters is a link between risk management and strategy. BTM incorporates in its internal perspective a risk management process similar to the Six Sigma linkage in many organizations' scorecards. This linkage is a result of BTM's goal to enhance its corporate governance, the achievement of which requires both superior strategy execution and robust risk management capabilities. Since the idea of linking risk management and strategy was first conceived, it has been improved many times conceptually and in practice. Today, this approach has become the enterprisewide standard.

The COSO Enterprise Risk Management Approach

The key concept that links strategy and risk management is the COSO[1] Enterprise Risk Management (ERM) system, a model developed last year by the North American consortium of accounting and finance professionals' associations. The previous version, known as the COSO Internal Control Framework, standardized the concept of internal control in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

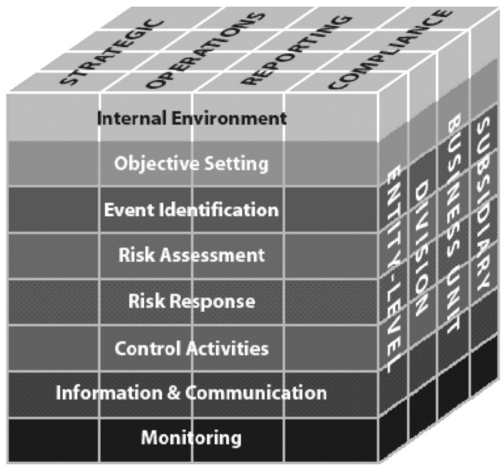
The new COSO ERM system, building on the internal control framework, encompasses the concept of broader, enterprisewide risk management—extending its coverage to risks that relate to strategies. COSO defines ERM as a process, put in place by an organization's board of directors, management, and others, designed to identify and manage the spectrum of risks an organization faces so that it can be reasonably assured of achieving its objectives.[2]

Interestingly, COSO created its Internal Control Framework in 1992, the same year that Robert Kaplan and David Norton introduced the Balanced Scorecard. Like the BSC, the COSO framework has evolved over time. The most critical aspect of its evolution is the new ERM model's emphasis on the importance of aligning strategy and risk management.

In an official publication about its ERM model, COSO claims "every entity exists to provide value," and that value "is maximized when management sets strategy and objectives to strike an optimal balance between return goals and related risks, and efficiently and effectively deploys resources in pursuit of the entity's objectives."[3] Graphically, the concept is depicted as the "COSO cube," familiar to the senior executives of publicly held U.S. companies, since COSO is essentially mandatory for compliance with the Sarbanes-Oxley Act. (See *Figure 1*.) Four categories of objective appear in the vertical columns: strategic, operations, reporting, and compliance. Eight components of risk management and internal controls are indicated in the horizontal rows: internal environment, objective setting, event identification, risk assessment, risk response, control activities, information and communication, and monitoring. In the third dimension are the organization's units.

In the banking industry, the COSO ERM model is a common risk management framework that is generally accepted by regulators, external and internal auditors,

Figure 1. The COSO Enterprise Risk Management Cube



The COSO cube depicts how four categories of objective—strategic, operations, reporting, and compliance—overlay the eight components of risk management and internal controls across all units of an enterprise.

and banking executives. As a result, regulatory supervision policies in many advanced countries such as the U.S. and Japan are fundamentally based on the COSO framework. Supranational regulatory bodies such as the Bank for International Settlements have also adopted the concept. Hence, particularly for large complex global banks, implementing the COSO ERM system within the organization is a de facto requirement for what regulators refer to as "safe and sound banking."

But the COSO ERM concept had never been tied explicitly to the BSC methodology. Scorecard literature typically highlights value-creation strategies such as growth and efficiency. But value loss prevention—the risk management aspect of these strategies—is rarely mentioned. Similarly, risk management literature tends to focus on risk measurement and assessment, seldom discussing the importance of how these risks align to strategic objectives.

For BTM, a strategy that lacks alignment to risk management is not only insufficient but downright dangerous. As the series of recent corporate failures indicates, the aggressive execution of a strategy that lacks appropriate checks and balances can result in disaster. Furthermore, BTM recognizes that risk management is pointless unless it is closely tied to the company's strategic objectives. After all, risks include all sorts of things—marketplace obstacles, legal hazards, inadequate or inefficient processes, and fraudulent activities—that might hinder an entity from achieving its objectives. How significant a risk is depends on the relative importance of the objectives it could affect. In short, strategy and risk management are two sides of the same coin; they must be considered in tandem. BTM's BSC reflects this notion.

Mapping the COSO ERM and the BSC

The BSC and the COSO ERM are largely complementary. For example, the BSC makes strategy everyone's job via cascading. Similarly, the COSO ERM model suggests that everyone in an entity has some responsibility for enterprise risk management. Given this commonality—that both strategy and risk management are everyone's job—the COSO ERM model can be mapped to the BSC according to its eight components of risk management and internal control (shown by the front face of the COSO ERM cube in Figure 1). In fact, this mapping is the key to integrating the two concepts virtually into one (see *Figure 2* on p. 14). Let's consider each COSO ERM component and how it can be linked to the BSC.

Internal Environment. This refers to top management's commitment to risk management. In the context of the BSC-COSO linkage, it is about management's determination to use the BSC with the COSO ERM system to enhance the organization's safety and soundness. This is akin to the best-practice concept of "Top leadership committed" in Strategy-Focused Organization Principle #1, "Mobilize Change Through Executive Leadership."

Objective Setting. COSO requires setting four categories of objectives—strategic, operations, reporting, and compliance. From the BSC viewpoint, strategic objectives are those closely associated with achieving the mission and vision of the organization, generally implemented via high-priority projects. Once they are cascaded down to the operational levels, they are translated into "operations" objectives. "Reporting" and "compliance" objectives fit well with social and regulatory strategic themes and objectives in the BSC, which generally show up in the internal and customer perspectives. CSR-related objectives also fit well in these categories.

The benefit of using the COSO ERM model in concert with the BSC is that it helps ensure that all the strategically important objectives of these four categories are included in the BSC, while keeping the organization strategy-focused.

Event Identification, Risk Assessment, Risk Response, and Control Activities. These four components comprise the heart of risk management.[4]

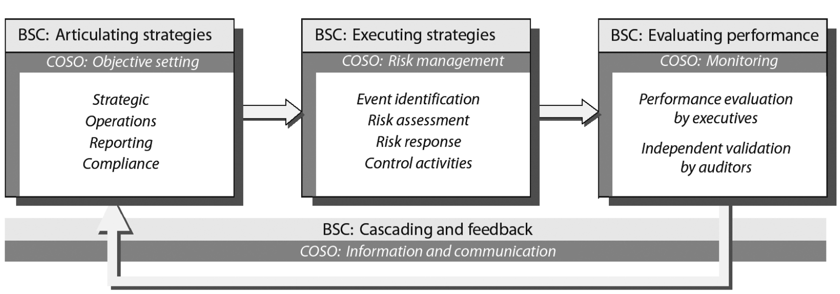
- *Event Identification:* Identifying the internal and external events that affect an organization's ability to achieve its objectives. In the banking industry, risk is typically classified into three categories: market, credit, and operational. All organizational units are responsible for identifying and managing operational risk, which includes legal and regulatory compliance risk. The treasury function is responsible for market risk. All lending-related areas are responsible for credit risk.
- *Risk Assessment:* Developing scenarios and calculating the likelihood, consequences, and potential costs (tangible and intangible) of each potential risk event. These scenarios are the basis on which the organization determines how it should manage risks.
- *Risk Response:* Having in place a plan to address risks either by avoiding, accepting, reducing, or sharing them. This involves aligning risks with the organization's risk tolerance and risk appetite.
- *Control Activities:* Establishing policies and procedures that help an organization efficiently and effectively carry out risk responses.

An organization is ready to execute these processes for proactive risk management once the four types of COSO objectives have been set. To make everyone more accountable for risk management performance, an organization would simply add objectives requiring these steps in every unit's BSC. This is the most significant benefit BSC brings to the COSO ERM model. For example, by setting a bankwide objective of implementing control self-assessment in every unit's BSC, everyone is required to go through these steps in the potential risk areas BTM faces.

Information and Communication. The COSO ERM model requires that relevant information be communicated vertically and horizontally within the organization to help people enact their risk management responsibilities. The BSC ensures that strategic information is cascaded down from the top down. Also, as indicated in the third dimension of the COSO ERM cube, the information flow applies across organizational levels. Additionally, the BSC/COSO-based double-feedback loop covers not only strategy-related information flows, but also those related to risk management. This accelerates organizational learning and alignment between strategy and risk management.

Monitoring. Monitoring is typically conducted by two parties: management and internal auditors. Management monitors performance of the organizational units using the BSC. Internal auditors, besides monitoring risk management within each organizational unit, validate whether the entire architecture of the strategy-risk linkage is working efficiently and effectively.

Figure 2. BSC–COSO ERM Mapping Chart



The elements of risk management defined by the COSO ERM model correspond to the three strategy-related processes defined by the BSC and to the BSC's feedback properties.

A Package Deal for Governance and Goal Achievement

The COSO ERM model expands the use of the BSC to cover the management of risks that might arise in the course of executing strategy. Therefore, when they are used properly together, management enhances the potential for achieving the organization's goals and objectives. In addition, by using BSC and the COSO ERM model as a "package" rather than separately, the organization achieves simplicity in governance while minimizing confusion. Although BTM's linkage is unique, it should be applicable to any organization that seeks to align strategy and risk management.

Moreover, just as the BSC has evolved over time, so we expect the BSC–COSO ERM linkage to do so at BTM. For the sake of the wider application of this linkage model, we expect, and hope, to see further study of it by strategists and risk managers. ■

[1] *COSO stands for the Committee of Sponsoring Organizations of the Treadway Commission. It was established by five*